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The relation between American life insurance...

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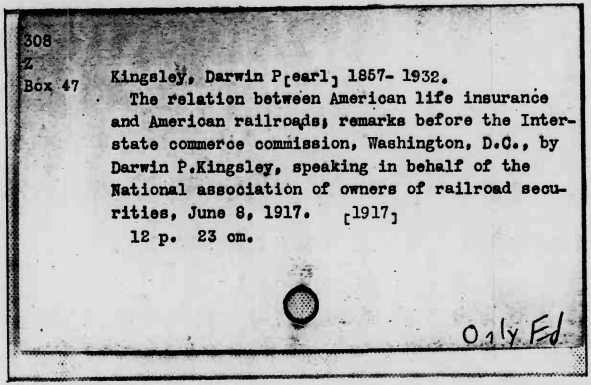
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THE RELATION BETWEEN

AMERICAN LIFE INSURANCE

AND

AMERICAN RAILROADS

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REMARKS BEFORE THE
INTERSTATE COMMERCE COMMISSION
WASHINGTON, D. C.

BY

DARWIN P. KINGSLEY

SPEAKING IN BEHALF OF THE NATIONAL ASSOCIATION
OF OWNERS OF RAILROAD SECURITIES

JUNE 8, 1917

Gentlemen of the Commission:

The Life Companies of the United States have a total of what we call "outstanding insurance"—that is the face of their promises to pay—aggregating $25,000,000,000.

At their face these contracts considerably exceed the present bonded debt of Great Britain, they are equal to about one-eighth the present estimated wealth of this Nation. The integrity of the enterprise therefore is a matter of capital importance. Because the investments of this enterprise in Railroad securities is now so large its problems can be complicated and its efficiency powerfully influenced by the future prosperity or otherwise of the properties you supervise and regulate.

To show how profoundly the future of American Life Insurance may be affected by the future prosperity or otherwise of American Railroads it is not enough merely to point to the great totals of Railroad securities held by the Life Companies. The total as of January 1, 1916 is so large, however, approximating at book value $1,583,000,000 (of which stocks amount to $39,000,000), that it requires no expert knowledge to recognize a vital relation here, viewing these investments merely as ordinary investments.

But the relation between these two great enterprises has an importance and carries an obligation which a mere statement of the gross investment does not convey. In order to show this, I shall have to state briefly what the Life Insurance contract is, how it has to be made, and its relation to these securities: Life Insurance contracts are in reality a type of serial non-interest bearing bonds. They mature daily through drawings. The drawing is done by Death, but the process is essentially the same as that followed in serial bond issues where the drawings are made from an urn. Bonds of States, Counties and Municipalities, running for a definite period, or due serially, usually have a sinking fund provision, and the sinking fund and interest are provided for by public taxation. These life insurance bonds also have a sinking fund provision, a very strict one, and these provisions are also met by taxation, by private taxation.

The Life Insurance Premium, outside the factor which represents endowment insurance, is a tax as clearly and unequivocally as that form of contribution to the public exchequer which we

call the Income Tax. Here, however, the analogy between Government bonds and the Life Insurance contract ends.

These civic subdivisions of the nation have practically unlimited capacity to meet their bond obligations through taxation. If the rate of tax fails to produce the annual interest charge and the proper annual addition to sinking funds, the rate can be raised and new sources of revenue created through new and different taxation. Not so with the Life Companies. Their obligations are fixed except as they are increased by forces beyond their control while their power to tax is strictly limited. They are obliged to state in advance in contracts that may mature to-morrow or in sixty years or more, just what the purchaser is to pay yearly, or half-yearly, or even weekly. That figure cannot under any circumstances be increased, not even in times of war. Within recent weeks hundreds of inquiries have come to the Home Offices of the Companies asking whether the Companies would now put a war clause in outstanding policies. The Companies cannot cross a "t" or dot an "i" in contracts outstanding. The extra mortality of war and the increased cost of labor and supplies must be covered by the premiums fixed when the contracts were made.

In fixing this premium the Life Companies have to make very broad and far-reaching assumptions as to what will happen in the world of business to-morrow and the next day and so on during the life of the contracts, some of which will run for many years. In fixing the annual charge the Companies first adopt a table of mortality. That with relative definiteness declares how many of these bonds will be drawn yearly, and experience now pretty conclusively shows that these maturities do not even in war-times exceed the provisions of the mortality tables. These are matters with which we have nothing to do here, and are stated because they are a part of the general plan. The mortality tables are now confirmed by vast experience, are used by all the Companies, and are sound. The Companies next assume a rate of interest, and that brings the peculiar relation between the Railroads and the Life Companies directly into this discussion. They assume that the proceeds of these private taxes, or premiums, can be invested to earn a minimum rate of interest through long periods of time. In doing this the Companies are obliged to assume that public faith will be kept and private credit will be sound. Starting with these assumptions it is not difficult for an Actuary to tell just what sums must be

set aside annually, if increased by the rate of interest assumed, to provide the funds to redeem these serial maturities. The Companies then add to this a percentage for expenses and other contingencies. But the mortality tables show that the number of drawings increases rapidly with advancing age of the bondholder, and as the Companies, in all the types of insurance involved in this discussion, propose to tax the man the same amount annually per $1,000 at age 80 that was required at age 15, if he entered then, the reserve, or sinking funds, must be sufficient to cover that period of the contract when by reason of increased age the demands on the Companies through maturities outrun the premiums. In short the bondholder in youth pays more than the mortality of youth requires in order to provide funds against the time when on account of age his annual contribution will be inadequate. This explains in part why the reserves of the Companies run into such large figures. But total assets of $5,700,000,000 against face obligations of $25,000,000,000 does not look disproportionate even to a layman. The two factors which make it possible for that $5,700,000,000 ultimately to meet obligations aggregating $25,000,000,000, are future premiums and interest. The report of the Insurance Department of the State of New York at the close of 1915 shows that the Life Companies reporting there, which of course does not include all the Life Companies in the United States, collected in the calendar year $212,000,000 in interest and dividends, exclusive of rents. Since organization American Life Companies had collected up to the close of 1915, in interest, dividends and rents, over $3,500,000,000. This is approximately 60% of their present assets. Broadly speaking, it was all necessary to make good the original assumptions as to interest, although there has been always a margin and there always must be.

Here then are two factors which lie at the basis of the structure of Life Insurance, factors that must be cardinal considerations in this discussion:

1st. Future obligations that are to be met by a level premium fixed in advance and as against all contingencies.

2d. An assumed rate of interest running far into the future.

Of these two, the second, for our discussion to-day, is much the more important because while the Companies cannot in any circumstances raise their premium, or rate of tax, as soon

as the bondholder fails to make his annual, or semi-annual, or weekly contribution, the Company's liability on that particular contract changes and it is automatically protected. Not so with the interest factor; that must be earned or the whole structure is threatened. Interest is assumed to be constant on all the money in the sinking fund. No allowance is made for any default. Acting within the law the reserves of most of the Companies reporting to the New York Department are calculated on the assumption they will earn 3½% and the State will compel a Company to cease issuing new contracts whenever its assets do not cover its liabilities, assuming that it will earn 4½%. It would appear that here is margin enough, and that is true if certain other assumptions made by the Companies do not fail. The Companies have to assume not merely the factors that enter into its premium rate, but, equally vital, that securities can always be had so sound and dependable that they will yield the rate of interest assumed and in addition will produce the principal invested whenever desired, or at maturity if bearing a fixed maturity date. The Companies' obligations do not shift with time and circumstance, except as premium payments fail or contracts mature or are surrendered; but its invested funds from which it is largely to meet those liabilities are open to all the assaults that lie in shifting economic conditions. Securities rated by experts as sound to-day are sometimes valueless in a few years. The Life Companies buy and must buy what every careful investor buys. In adopting a level tax, or premium, for long periods the Companies are obliged to assume that through all that time commercial faith will be kept, that sound and necessary enterprises will be fostered by society, **and that the State which so sternly supervises the Companies, so strictly measures their liabilities, and so carefully values their assets, will use the same power to see that the faith that lies back of these securities is also kept.**

In two particulars the state, meaning the Federal Government, and the states, meaning the members of the Federal Union, have taken action that directly affects the fundamental assumptions of the Companies:

1st. Through taxation which weakens the assumptions.

2d. Through supervisory bodies like this, having the power to regulate and limit the earnings of public carriers which should strengthen the assumptions.

Consider the matter of taxation. Of course every dollar taken from Life Insurance Companies by the state, or the states, is an expense not covered by the Companies' fundamental assumption and therefore must come out of the loading for contingencies which is also unchangeable or out of other savings which are about as likely to decrease as to increase. It is a tax on a tax, and while I appreciate that this is not a body having to do with taxes, it is a co-ordinate branch of Government and is bound to take cognizance of other Governmental action. These taxes now total $15,000,000 more or less a year and are steadily rising. Recent legislation has put mutual insurance, which is not a business enterprise at all, has no profits and in the nature of things can have none, in the category with munition makers. Taxation is an increasingly serious factor in the Companies' balance sheets. It is quite within the realm of things possible that this tax will rise to $30,000,000 a year at no distant date. Against this extraordinary and increasing demand the Companies have no protection. They constantly eat into the margins saved by economies in management, savings in mortality, and savings in interest.

Life Insurance in a word faces increasing obligations which it does not create, which it cannot control. These demands are additional to those named in the life contract itself and must be met from revenues that are substantially fixed. The situation obviously becomes at once extremely uncomfortable if we add to these expenditures any failure in the Companies' fundamental assumptions.

This body has the power to fix the rates charged by the Railroads having to do with Interstate Commerce. The greater part of the investments under discussion was made before your honorable body was granted, or at least before it exercised, its present powers. You therefore inherit a condition which makes the integrity of these 46,000,000 contracts a part of your duty.

If a denial of the prayer of the roads for an increase in rates at this time will carry the relation between the railroads and the Life Insurance companies into a doubtful zone and even remotely assail the assumptions as to interest which the Companies have made and imperil the capital which they have invested, then we assume that this body is as clearly bound to grant that request in the interest of public faith and commercial integrity as it

is bound to prohibit unwise methods of financing and to end exorbitant or discriminatory charges.

It is not my part to go into the statistics of this problem. The facts and figures are all before you now. I know no more about that than any other non-railroad man. I am here to reflect, and I think I do reflect, the deliberate judgment of the men who are responsible as Trustees for investments aggregating nearly $6,000,000,000, of which Railroad securities represent 25%.

I speak directly, and by authority, on behalf of five great Companies which together own 75% of the total railroad holdings of all the Companies. They have steadily lost faith in what was at one time a favorite investment. The per cent. which expresses the relation between their holding of railroad securities and their ledger assets has declined within ten years. In the case of the largest single holder this per cent. in the year 1904 was 55.1% and in 1916 it was 38%.

What conditions explain this attitude?

Into the judgment which has made these investors draw away from Railroad securities the product of three tests or conditions have entered. These are:

The Factor of Safety;

The mean market price of a selected group of bonds; and

Defaults.

The Finance or Investing Committees generally apply to a Railroad bond offering, the test of Safety. What is the bond's Factor of Safety? If it is unsatisfactory, the offering is not considered further.

In addition the Companies—most of them I think—periodically apply this test to their entire holdings. Applied through a period of years to the holdings of one Company, the largest single holder of Railroad bonds, the test yields these results:

FACTOR OF SAFETY

Close of 1912	204 issues	average factor	73
Close of 1913	217 issues	"	70.8
Close of 1914	236 issues	"	65.1
Close of 1915	238 issues	"	70.7
Close of 1916	232 issues	"	81

It is not difficult therefore to understand why this particular Company, which in 1902 invested 117.3% of its entire increase

in assets that year in Railroad bonds, invested in long time bonds only 3½% of such increase in 1913.

This test runs parallel with what is common knowledge.

Nineteen sixteen is generally known to have been an abnormally good year with nearly all the Roads. The improved net earnings of the year lifted this Company's Factor of Safety nearly sixteen points above 1914.

For a period of years the second test has yielded similar results.

The mean market price of twenty-five selected bond issues declined steadily from 97.25 in 1909 to 86.92 in 1915. The price improved materially in 1916 but is now lower than the mean price of 1915.

By itself a considerable fall in the market price of these bonds may mean little. The earning power of money fluctuates and market prices vary correspondingly. The bonds are bought to yield a rate of interest and are usually carried to maturity. Unless the market price meantime reflects weakness in the security, it is of little importance in the Companies' calculations. But when along with falling market prices and a shrinking Factor of Safety come such defaults as are recorded in the story of the last nine years the attitude of these and other investors is easily understood.

The Directors of a Life Company may have to face problems here before default occurs. Under the laws of New York the Companies must value any particular issue at market, in making its return to the State, whenever the Superintendent of Insurance decides that it is inadequately secured. The difference is charged to profit and loss and increases the cost of insurance for the whole Company to that extent.

On January 1, 1916, the market value of the group of Railroad bonds under consideration was $107,000,000 below amortized value.

Taking up the third test, we find that within nine years Railroad bonds of a par value of $844,534,000 have defaulted their interest and that the amount of interest in cumulative default July 1, 1916, was $82,000,000. The year 1916 seemed to forecast a complete and permanent change in the situation.

But now the Roads—many of them at least—face new and what seem to be even graver problems. Like the increasing taxes on Life Insurance there now comes to the Roads an almost

perpendicular raise in the cost of labor, material and equipment, and in addition the as yet indeterminable costs of war.

Recent monthly returns from some of the great systems indicate that the margins of 1916 will not be maintained or approached in 1917. Except in your discretion rates are inflexible as against these rising demands.

The factor of safety which was none too high at the close of 1916 is already receding and will continue to recede unless the Roads have relief. Standing at 65 the Factor applied to these seasoned and carefully selected bonds obviously indicated great danger to Railroad securities as a whole. In the first six months of that year—1914—Railroad bonds aggregating at par over $291,636,000 defaulted on nearly $11,000,000 of interest. Some of the defaulting bonds were in the vaults of the Life Companies, but not many.

Look through the Life Companies' sworn reports to the State of New York at the close of 1916 and you will find that they now buy few junior bonds except where the road is paying substantial returns on its stock. The law of New York State no longer allows them to buy stocks or debentures, or collateral trust bonds except under certain conditions. They confine themselves, and largely from choice, to underlying bonds, which of course means that in any new financing of the Roads the old market for the securities which represent that financing, is gone. It does not take a railroad expert to understand that an equipment trust to-day representing 80% of cost, when that cost is nearly twice what it was a few years ago is not a good investment unless it appears that there has been a corresponding increase in the earning power of the equipment itself. An inevitable question springing from that conclusion is: What effect will the present startling advance in cost not only of equipment, but of labor and coal and other items of upkeep have on the outstanding securities of the Roads unless their rates which are now about as rigid as Life Insurance premiums, can be modified to meet changed or emergency conditions?

If a Road is to serve the country effectively it must be able to finance itself. To sell its securities to Life Insurance Companies hereafter a Railroad must show that its revenues are sufficient to cover depreciation, upkeep, interest, amortization, and a reasonable surplus after paying the stockholder a fair return on his money. When the present holdings of the Life Companies were purchased,

barring possibly the underlying obligations of some Roads, these conditions generally existed. What is the condition now? How many roads can finance themselves to any considerable extent through the sale of stock? How many indeed from their present indicated net earnings will be able to pay any return to stockholders in 1918 if the properties are well kept up?

Having spoken so frankly, it seems wise, to avoid misunderstanding, that I should say a word more. The facts are as I have stated them, but while, unless remedied, they threaten loss to the Companies they do not threaten disaster. It is in part to avoid the future possibility of that I have spoken so freely to-day. These Companies for which I speak not only seek safety but as they furnish this mutual protection at cost they aim to reach the lowest net cost. That they are bound to do. Every million dollars paid in taxes, every million dollars in defaulted interest, every million dollars shrinkage in principal, goes into profit and loss and by that much increases the cost of insurance.

Life Insurance Directors do not expect to invest billions and keep them invested for long periods without loss. But they do believe that when the Federal Government placed—and properly placed—in your hands the power to regulate and supervise these Roads and the power to fix their rates, it assumed a responsibility toward the people we serve, so clear and compelling that our losses in this group of securities ought to be less than in any other group of securities outside Government and State bonds.

One word on the strictly human side.

I speak for about 33,000,000 investors; and here again we must discriminate. Ninety per cent. of that vast number are in such financial condition that they do not know that they have a dollar invested in anything. Acting separately few of that great number would to-day own or have an interest in any security. In its usual significance therefore the word "investor" does not apply to any of these people. The real investor has money otherwise idle; he buys a bond, or shares of stock, or a farm, or an interest in a business. He invests and takes the risk of gain or loss. These 33,000,000 people (even those having means) do nothing of that kind when they insure their lives. They mutually agree to submit to a tax for a definite social purpose; they are not seeking profits; they are not in business; they are mutually capitalizing the future earning power of their lives, the capital to become available as drawings are made by

the grim laws of mortality. To do that scientifically these reserves are necessary and the reserves must be invested, but the men who pay the taxes agreed to are scarcely more investors than are the men who donate funds to colleges, hospitals and orphan asylums. Such funds must be invested, but the beneficiaries of these donations are not investors unless perchance a man who founds a hospital and goes there to die may be called an investor. The insured pays his tax because of the strong probability that his family otherwise may be left defenceless. The man who pays the tax wins nothing for himself even if his bond is drawn early—except a sense of self-respect and comfort meantime.

By this device 33,000,000 people have erected a great sociological plant which in turn has become a great investor. They have mobilized the single dollars and the ten cent pieces. They have assembled money otherwise naturally ineffective, unrelated, possibly even hostile, and thereby, and properly as a by-product, they now indirectly own one-tenth of all the financial obligations of all the Railroads; they have helped to build up great cities through mortgage loans; they have financed public improvements through municipal bonds; they have financed the farmer through farm loans; and are now about to pour millions into the United States Treasury in the purchase of Government bonds.

These 33,000,000 people have trusted the Directors of their enterprises completely. That is a very important economic fact. That faith must be kept. The Directors in turn have founded their structure on certain assumptions that are absolutely sound, if public faith is kept.

I am here, therefore, not to plead for the private investor, although I know of no good reason why an honest investor, a holder of Railroad bonds, even a holder of Railroad stocks, is not entitled to a fair return on a naturally sound investment.

The people for whom I speak had no money to invest, sought no investment, and, as insurants, have now no title to any specific bond or share of stock. They have contractual rights and that is all.

Having been granted and having assumed the power to regulate these public carriers and to fix their rates, it follows that in all cases where Insurance Directors have bought Railroad Securities with sound judgment, your duty to use your power to protect the integrity of these securities is akin at least to the duty of the Government to protect the lives and liberties of the people.

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